Discussion of
The Dynamics of the Real Exchange Rate: A Bayesian Approach
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RER Dynamics

- Two main puzzles in international macroeconomics are:
  - Volatility and persistence of real exchange rates.
  - Lack of risk sharing: negative correlation of real exchange rates and relative consumption among countries.

HP-Filtered Data					
	Consumption Euro	Output Euro	Consumption USA	Output USA	Real Exch. Rate
Std. Dev.	0.91	1.01	1.28	1.58	7.83
Corr. with RER	-0.26	-0.06	-0.02	-0.08	1.00
First Autocorr.	0.84	0.86	0.87	0.87	0.83
	Consumption Euro, USA	Output Euro, USA	Relative Cons., RER	Relative Outputs, RER	
Other Correlations	0.33	0.47	-0.17	0.04	

Note: Relative variables are the ratio between the euro area variable and its US counterpart.

RER Dynamics

- CKM (RES, 2002) propose two important alternatives to explain both facts:
  - The introduction of nominal rigidities, in particular in the price of imported goods: $q_t = s_t + p_t^* - p_t$.
  - Introduction of incomplete markets: $q_t = c_t - c_t^*$
  - CKM found that monetary shocks with a high degree of risk aversion and sticky prices with local currency pricing can explain real exchange rate volatility and to less extent, its persistence.
- But regardless of the asset market structure it is not possible to solve the real exchange rate/consumption *anomaly*, even with additional real and nominal rigidities.

What do the authors do?

- Evaluate empirically the role of frictions and nominal rigidities in characterizing the RER dynamics.

- USA and Euro Area (C,C* CPI,CPI*, NT_CPI, NT_CPI*, I,I*,RER)

How?

- Non Traded Goods and Distribution Services into a NOEM (BNR, JME 2003)

- Bayesian Estimation

What do they find?

- Distribution costs + nominal rigidities are important.

- RER decomposition: Price discrimination explains 56%, home bias explains 7%. Combination of home bias and Price discrimination =34%

Comment I: Why Internal RER is not important?

- Surprising result. Since, without NT goods there is no room for distribution costs.
- Hence, the endogenous reduction of the price elasticity of demand should be significant.
- The estimated values of the elasticity of substitution does not change significantly across spesifications.
- Very tight prior for this elasticity.

Comment I: Why Internal RER are not important?

- Betts and Kehoe (JME 2005): Relative Price of NT goods account for 1/3 of the RER fluctuations. Disaggregated data of tradable sectors permits to obtain implicitly the internal RER.
- Burstein, Eichenbaum and Rebelo (2005): They account for roughly 50% of the cyclical moments of the RER (they use price of tradable good a the dock, X and M prices).

- **Q = lop+(2h-1)*tot +(PT/PNT-PT*/PNT*)**

Comment III: Wealth Effects

- financial autarky would mean that (regardless of preference shocks, habit formation, and others):

$$\left(\tilde{c}_t - \tilde{c}_t^*\right) = \left[\frac{2\theta(1-\delta)-1}{1-2\delta}\right] q_t$$

Comment II: The Consumption Real Exchange Rate Anomaly

- Are we getting closer to explain it?
- UIP shocks explain 78% of RER. Hence, there is no fundamental explanation for RER dynamics.
- Is there any cross-correlation that LCP and distribution costs help to match? Tension
- Table 8B. UIP and Preferences shocks are important. How are they related to the extensions?: LCP and distribution costs.

i.e Mechanism

- Productivity shock in tradable sector

$$\uparrow A^H \rightarrow \uparrow Y \rightarrow \uparrow C \rightarrow \uparrow Assets(wealth) \rightarrow \downarrow L^S \rightarrow \uparrow W$$

$$\uparrow W > \uparrow A^H \rightarrow \uparrow \left(\frac{W}{A}\right) \rightarrow \uparrow P^H \rightarrow \downarrow Q = \frac{P^*}{f(P^H)}$$

What about Valuation Effects?

- Gourinchas and Rey (2005): Valuation effects are important explaining RER dynamics in US.....(positive wealth effect!!!)
- So they might be also key in explaining the Backus-Smith puzzle
- To what extent UIP shocks are capturing valuation effects?
- Valuation effects might also be important in developing economies.

Conclusion

- The paper contributes to the debate on RER dynamics.

- A deeper understanding of the link between non-structural shocks and key macro variables is important.